CONCLUSION

CompTel hereby requests that the Commission adopt the rulings as requested herein and in the filings today of the UNE-P Coalition and the Loop-Transport Coalition.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I, Theresa A. Baum, hereby certify that on this 4th day of October 2004, a true and correct copy of the foregoing **Comments of CompTel/ASCENT Alliance**, was hand delivered upon the following:

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ATTACHMENT 1

COMPETITION IN ACCESS MARKETS: REALITY OR ILLUSION

A Proposal for Regulating Uncertain Markets

Prepared for the

Ad Hoc Telecommunications Users Committee

August 2004

ECONOMICS AND TECHNOLOGY, INC.

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Preface | COMPETITION IN ACCESS MARKETS: REALITY OR ILLUSION A Proposal for Regulating Uncertain Markets

The Ad Hoc Telecommunications Users Committee is a group of large corporate telecommunications customers whose members collectively purchase more than $2-billion worth of local and long distance, voice and data, conventional and advanced telecommunications services annually. Committee members include some of the nation's largest and most sophisticated corporate buyers of telecommunications services, thirteen of which are in the Fortune 500 and nine of which are in the Fortune 100. The members of Ad Hoc represent a broad range of industry sectors (including manufacturing, financial services, insurance, retail, and information technology).

As an active participant on behalf of large user concerns in FCC rate and policymaking proceedings for nearly three decades, the Ad Hoc Committee has consistently advocated policies aimed at facilitating the development of competition in all telecom sectors, and has supported a variety of deregulatory initiatives wherever competition has obviated the continuing need for regulation as a means for assuring competitive market outcomes. Indeed, no customers would likely benefit more from the development of robust competition and the reliance upon markets rather than regulation than Ad Hoc's members. However, where effective and sustainable competition is not present or not feasible, the Committee believes that ongoing *and effective* regulation is essential, both to afford entrants a fair opportunity to compete and to assure customers fair, just and reasonable prices where competition is not capable of assuring that result.

To be sure, competition has arisen in a number of telecom industry sectors, but one key area that remains monopolized by incumbent local exchange carriers is the market for *access services* – switched and dedicated "last mile" connections between interexchange carrier networks and local end users. In the Committee members' experience, deregulatory initiatives with respect to access services – in the form of ILEC pricing and earnings flexibility – have been premature, and have often resulted in persistently excessive prices, operating to frustrate, rather than to facilitate, competition in this sector.

In that context, the Ad Hoc Committee has asked Economics and Technology Inc., as its economic and policy advisors, to examine the current state of the access services market and to formulate a plan for a regulatory paradigm capable of affording incumbent local carriers the flexibility they require to meet actual competitive challenges where these exist, while at the same time protecting customers against excessive monopoly prices and practices where the ILEC access services monopoly remains intact. This paper sets forth the results of that effort.

This paper was prepared by Lee L. Selwyn, Susan M. Gately and Helen E. Golding. The authors gratefully acknowledge the contributions and assistance provided by the Committee's legal counsel, James S. Blaszak and Colleen L. Boothby of Levine, Blaszak, Block and Boothby, LLP, as well as the invaluable assistance of numerous Committee members.

Boston, Massachusetts
August 2004

Executive Summary

COMPETITION IN ACCESS MARKETS: REALITY OR ILLUSION
A Proposal for Regulating Uncertain Markets

The illusion of a competitive access services market

The incumbent local telephone companies (ILECs) – the very entities that have the most to gain by mischaracterizing the current state of the market – contend that competition is rampant across the country and in all sectors of the US telecom industry, and that competition is growing day by day. Their rhetoric, however, clearly does not square with marketplace reality. Unlike competing *providers* of access services, as *users* of these services, members of the Ad Hoc Telecommunications Users Committee (*Ad Hoc*) – some of the largest consumers of telecommunications services in the country – have no commercial self-interest in maintaining unnecessary regulation on any class of service providers. Indeed, as high-volume purchasers of telecommunications services, Ad Hoc members have been among the first to benefit from efforts at telecom deregulation and, as a consequence, Ad Hoc has consistently advocated deregulation wherever actual and effective competition in specific service markets has emerged.

However, the level and extent of actual competition in the telecommunications market being experienced by Ad Hoc Committee members regrettably falls far short of the hyper-competitive market that incumbent local exchange carriers seek to portray. No customers would benefit more from robust competition and the elimination of needless regulation than members of the Ad Hoc Committee. However, because effective competition has not materialized, the diluted regulatory framework adopted *in anticipation of* competition has actually resulted in higher prices, grossly excessive profits for the incumbents and, ironically, less competition overall. Every day that the FCC allows to pass before correcting this regulatory deficiency costs business and government users more than $15-million in excessive special access prices – and maintains in place an unjustified windfall for the ILECs, which in 2003 resulted in RBOC profits (realized rates of return) on special access services averaging a jaw-

dropping 43.7%. The marketplace conduct of the dominant ILECs – raising prices in precisely those geographic areas in which "competition" is presumed to have materialized – would not be possible if actual competition was in fact present, and thus demonstrates and confirms the "on the ground" experience of Ad Hoc members as to the utter lack of such competition. If users confronted actual competitive choices for ILEC switched and special access services, the ILECs would be forced by competitors to lower their prices rather than increasing them, and ILEC earnings would be moving down toward competitive levels, not rising to astronomical heights.

The lack of alternatives to ILEC switched and special access services

One area where the assumptions about the presence of competition have been furthest from reality is *access services*, the means by which long distance carriers are afforded use of local telco facilities to connect their networks to end user customer locations. There are two principal types of access services – *switched access* and *special access*. Switched access is provided in connection with most types of long distance calls, establishing temporary connections (between the long distance network and the local customer at each end of a call) that are disconnected when the parties hang up. For customer locations with relatively high volume (outbound or inbound) calling requirements, a dedicated (special access) connection is typically more efficient because, among other things, its use eliminates the need for repetitive switching operations involving the same customer locations.

Intuitively, one might assume that large users' needs are confined primarily to large buildings and commercial centers at which competing services will be readily available. However, corporate networks frequently involve thousands or even tens of thousands of individual sites – the vast majority of which have relatively low-volume – yet still mission-critical – telecom needs and are located in places where the ILEC is the *only* source of access connectivity. In order to effectively manage their overall telecommunications costs, corporate customers cannot ignore systematic overpricing to these myriad small-to-medium sized locations.

Although there is intense competition for interexchange switched voice and dedicated voice and data services – where interexchange carriers (IXCs) have competed robustly for over two decades – the ILEC monopoly over switched and dedicated access connections (the link between those interexchange carrier networks and individual end-user sites) persists largely unchallenged. As demonstrated in Chapter 2 of this paper and as confirmed by the repeated experience of Ad Hoc Committee members regularly doing business in the telecom marketplace, competition for switched access services is all but nonexistent, and while limited alternatives exist for special access, the incumbent local exchange carriers remain the sole source of connectivity at roughly 98% of all business premises nationwide, even for the largest corporate users. The lack of competitive alternatives for access services – including high capacity access services – is attributable to the numerous and well-recognized barriers to competitive entry, especially the enormously high fixed-cost investments required to enter this market coupled with the increasingly uncertain future return on those investments. These conditions, which are not likely to change any time soon, mean that, for large as well as small users, prices for telecommunications

services are not being effectively constrained by competition, *and are likely to rise as what little competition that now exists continues to falter.*

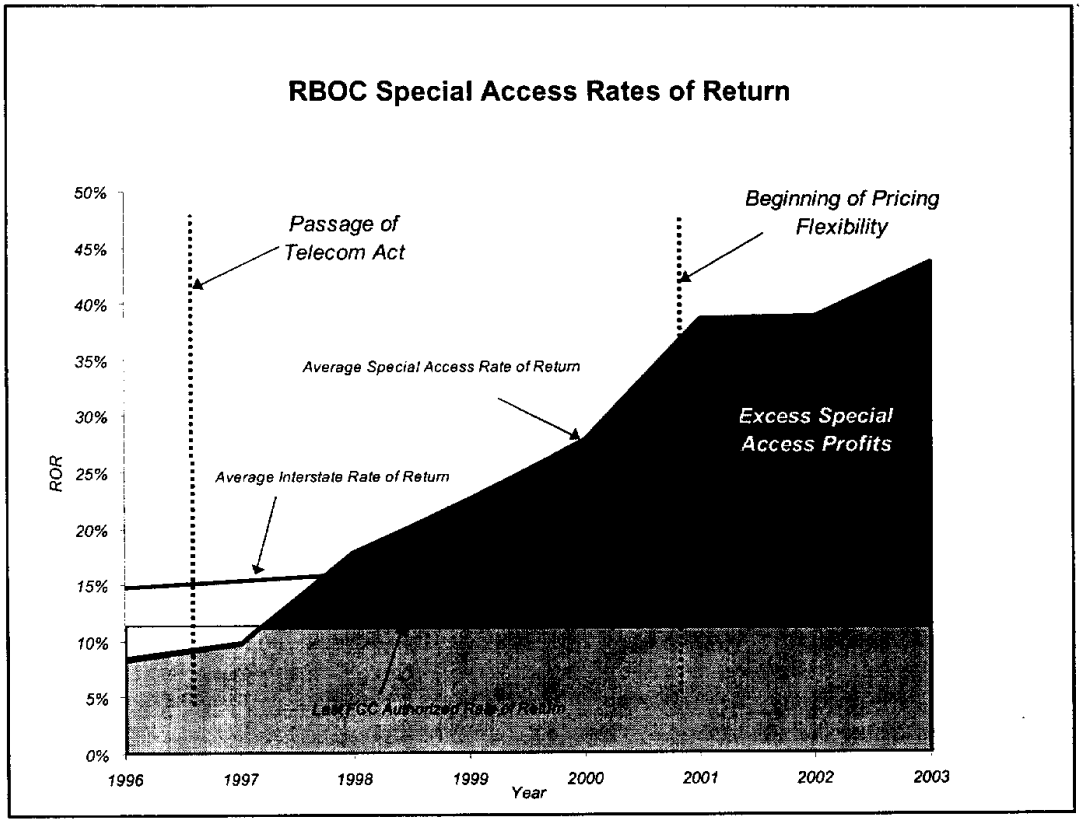
ILEC profits on access services exceed anything that would be expected to arise under competitive market conditions

The rates for access services – "access charges" – were introduced in 1984 in the aftermath of the break-up of the former Bell System. Special access rates – charges for dedicated connections between end users and their long distance carrier – are nominally subject to annual price cap rate adjustments which, due to low current economywide inflation rates, would typically require annual rate *decreases*. However, in those geographic markets in which the FCC deems certain "competitive triggers" to have been met, ILECs are exempt from making these required downward adjustments in their special access rates. These "exempt" markets now account for the vast majority of all special access services. In these areas, ILECs are afforded "pricing flexibility" and are allowed to increase or decrease rates as they see fit. Significantly, evidence that we present in Chapter 3 illustrates that in these "pricing flexibility" markets, special access rates have either increased or have not been decreased, as would have been required under the price cap rules. Ironically and counter-intuitively, special access rates in the putatively "competitive" geographic markets are now actually *higher* than those in effect in areas where the ILECs' monopoly is officially deemed still to be in full force.

Switched access rates – for the ILEC-owned segment of dial-up long distance calls – also remain well above cost and well above the rates for comparable use of the switched network for other types of calls (e.g., local and wireless). In addition to covering the cost of access to the ILEC's network, switched access charges also include a portion of the subsidy to basic local service that has been incorporated into long distance rates since long before the Bell System break-up. Although this subsidy component has been decreasing through a series of transition mechanisms, switched access rates are still set well above cost at "target" levels adopted in the so-called *CALLS* settlement in 2000. However, contrary to the FCC's expectations at the time it approved the *CALLS* settlement, "competition" has not continued to push switched access prices down towards costs following the elimination of X-factor reductions; in fact, precisely the opposite appears to have occurred.

Access service prices remain at large multiples of cost, and have actually been increasing such that their profitability far exceeds "competitive" levels. The FCC last established an "authorized rate of return" for the RBOCs at 11.25% in 1990 – at a time when market interest rates were considerably higher than those in effect today. However, with respect to special access services in particular and as a direct consequence of their FCC-sanctioned pricing flexibility, the RBOCs are now earning from two to four times that 11.25% rate of return level. As we discuss in detail in Chapter 3, and as is illustrated in the figure on the following page, the average return on special access services has been climbing steadily since 1996. The reported average special access return across the RBOCs for 2003 was 43.7%. Verizon's return on special access for 2003 was 23.5%, and BellSouth's and Qwest's were at the rarified level of 56.6% and 57%, respectively. Total interstate earnings for the RBOCs – switched and special

access, and common line combined – averaged in excess of 17.1%. Earnings levels of these extreme magnitudes could not be maintained if the competition that the RBOCs claim to confront were actually present.



Average RBOC Special Access realized rates of return. 1996-2003.

The Ad Hoc Committee's Solution: A regulatory model that would give ILECs the freedom to cut prices in response to competition while protecting consumers from price increases resulting from inadequate competition

Continuing to regulate a market that is effectively competitive – or failing to adequately regulate a market still dominated by an incumbent monopolist – would in each case be highly inefficient and certainly counterproductive. What is needed is a regulatory plan that will be both sufficiently robust to accommodate a wide spectrum of competitive conditions and sufficiently flexible so as to respond rapidly to changing competitive conditions with minimal disruption or delay. This paper presents the Ad Hoc Committee's solution – a plan that would

- curb the pricing excesses that have arisen in the absence of effective competition by re-targeting access prices back to competitive levels, and that, going forward,

- would establish a *self-executing regulatory paradigm* that will allow the ILECs the flexibility they demand while at the same time relying upon regulation to continue to protect customers against excessive prices if, in the end, actual competition fails to materialize.

The Ad Hoc plan is self-executing in that it would automatically cease imposing operative pricing constraints as soon as marketplace forces take over that function.

Initially, the Ad Hoc plan would re-target special access rates at the 11.25% authorized rate of return so as to eliminate the monopoly prices that presently exist. Thereafter, it would allow ILECs *downward* pricing flexibility, enabling them to respond to competition while assuring that prices remain at competitive levels where actual entry does not occur. And, in order to ensure that prices remain at competitive levels where actual entry does not occur, the ILECs' access rates would once again be adjusted annually by a price cap rate adjustment mechanism that includes a productivity adjustment ("X-factor") and an earnings sharing component.

US telecommunications policy continues to be driven in large part by the fundamentally *factual* questions as to precisely how much competition is present and how much competition is sufficient to replace regulation in assuring a competitive outcome. These questions remain highly controversial and even after the Commission makes findings regarding competitive conditions, persistent challenges mean that they must be revisited again and again. Ad Hoc's *self-executing* plan gets past this contentious debate because it will operate correctly under either monopoly or competitive conditions. If, as Ad Hoc and many other stakeholders believe, competition is not yet sufficient to constrain ILEC pricing, then re-targeting and applying price cap adjustments to ILEC rates with respect to their upper pricing limits will assure that end users will not be subject to excessive monopoly prices. On the other hand, if the market is – or becomes – effectively competitive, the ILECs will have the full and unconstrained ability to respond to such competition by lowering prices. Ad Hoc's plan will assure a win-win-win result by affording consumers competitive-level pricing whether or not actual competition is present, by affording interexchange carriers fair, reasonable and nondiscriminatory access to ILEC networks, and by affording the incumbent telcos the ability to rapidly respond to *legitimate* competitive challenges.

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FIGURES

1 A TWO-PRONGED APPROACH TO ACCESS REFORM

The members of the Ad Hoc Telecommunications Users Committee, representing some of the largest corporate telecom purchasers in the US with combined annual spends in excess of $2-billion, would theoretically be the most likely of all customers to experience the benefits of competition in their everyday procurement of telecommunications services – but the reality is that they do not. This paper presents the Ad Hoc Committee's proposal for re-targeting access prices back to competitive levels and for a self-executing regulatory paradigm that will allow the ILECs the flexibility they demand while at the same time protecting customers against excessive prices if actual competition fails to materialize. Initially, the Ad Hoc plan would re-target access rates at the 11.25% authorized rate of return so as to eliminate monopoly prices. Thereafter, it would allow ILECs downward pricing flexibility enabling them to respond to competition. However, to ensure that prices remain at competitive levels where actual entry does not occur, access rates need to once again be adjusted annually by a price cap rate adjustment mechanism that includes a productivity adjustment ("X-factor") and an earnings sharing component.

Rumors of the demise of the ILEC access services monopoly are highly exaggerated

There is growing folklore in Washington that local telecom markets are now fully competitive, and particularly so in urban areas where business customers are located. The Ad Hoc Telecommunications Users Committee ("Ad Hoc"), whose members include some of the largest corporate telecom consumers in the nation with combined annual telecom spending in excess of $2-billion, has on numerous occasions advised the Commission that this view of the status of competition – while optimistic and appealing in theory – does not track with the reality in the local telecom marketplace, even for purchasers with greater than average buying power.

ILECs portray a picture of effective competition for access services and on that basis contend that they require increased regulatory flexibility, if not outright deregulation, in order to respond to competitive challenges. Competitive local exchange carriers ("CLECs") and long distance carriers ("IXCs"), on the other hand, maintain that whatever limited competition they are able to offer is utterly dependent upon continued and uninterrupted access to the incumbent carriers' networks at economically-based prices. They point out that, without such access, the small amount of local market competition that presently exists would rapidly evaporate. Where ILECs seek to hold out what little competition that may exist as the basis for relieving them of numerous regulatory constraints and obligations, CLECs see continued ILEC regulation as critical to their survival.

As users, Ad Hoc members have no vested interest in either the ILEC or the CLEC/IXC positions. Large users are interested in obtaining the best prices – i.e., prices that reflect a robust competitive market – and they value true competition because of the cost and operational advantages that result from having alternative service providers. From where Ad Hoc sits, there is a fundamental disconnect between the ILECs' claims about competition in the special and switched access markets and what Ad Hoc members actually experience in their everyday procurement of telecom services.

The Committee's concerns differ from those of CLECs and IXCs. From the standpoint of *purchasers* of end-user services, premature deregulation of ILEC rates permits prices to increase – sometimes dramatically – where actual competition is not present. These concerns are not merely theoretical. As the ILECs have been allowed increased "pricing flexibility" for services that confront little or no actual competition, they have not decreased prices as one would expect in a competitive marketplace. Instead prices in markets granted pricing flexibility are now *higher* than prices in the more heavily regulated areas.

The purpose of this paper is to focus attention upon regulatory concerns that are specific, albeit not necessarily unique, to *end users*. The paper has two principal objectives:

- To demonstrate that competitive alternatives for the provision of local service and dedicated special access facilities to large business users are extremely limited, where they exist at all, and are certainly not sufficient to constrain the behavior of dominant carriers and to protect large business users from ILEC abuse of monopoly power. Evidence of the limited competition for access facilities – both special and switched – is presented in Chapter 2. In Chapter 3, we discuss ILEC over-earnings on special access in particular: evidence that prices – even for high capacity services required by large users – are not being constrained by competition.

- To describe a revised regulatory regime for access services that will properly regulate access services where a sufficient level of competition to constrain prices has yet to develop, while at the same time implementing a self-executing plan for reducing regulation (and allowing the ILECs the freedom to compete).

The need exists for a self-executing regulatory mechanism that gives ILECs the freedom to cut prices in response to competition while protecting consumers from price increases resulting from inadequate competition

For several years, the FCC has been attempting to navigate the line between monopoly and competition, attempting to design and to apply a degree of regulation appropriate to each market condition. To do this successfully the Commission is required to make a detailed and, more importantly, an accurate assessment of the actual state of competition. Continuing to regulate a market that is effectively competitive, or failing to adequately regulate a market still dominated by an incumbent monopolist, would in each case be highly inefficient and certainly counterproductive. The Commission's task is made all the more difficult by the highly fluid nature of telecommunications markets and technology. Protracted rulemakings and other regulatory proceedings increase competitive risk, discourage capital investment in competitive ventures, and (wittingly or unwittingly) work to solidify, rather than to challenge, RBOC dominance.

What is needed now is a regulatory plan that will be both sufficiently robust to accommodate a wide range of fact sets, and sufficiently flexible as to respond rapidly to changing competitive conditions with minimal disruption or delay. With respect to the regulation of access services, the FCC needs to remove itself from the continuing battle over whether and where true competition exists. Instead, the FCC should implement a regulatory mechanism that would include appropriate protections for users of access services by eliminating the excessive prices currently in effect where competition is not present, while concurrently affording ILECs the flexibility and freedom from regulation that they need to compete in those situations in which rivals are active in a particular geographic market area or service segment.

Ad Hoc's self-executing plan for pricing flexibility

Ad Hoc's proposal has the two-pronged objective of (1) eliminating excess monopoly prices for essential services that confront no effective competitive alternative; and (2) assuring ILECs the ability to adjust their prices and service offerings where a response to actual competitive entry is required.

- *Eliminate excess monopoly prices.* Access price levels are grossly excessive by any of several standards. First, they are pegged to historic embedded costs *as they existed in the late 1980s*, not to the significantly lower forward-looking economic cost that applies with respect to prices for other essential services, most particularly Unbundled Network Elements (UNEs). Second, special access service prices are currently set well in excess of those historic embedded costs, generating profit levels for the ILECs (expressed in terms of total return on investment) in the 23% to 69% range. Ultimately, the regulatory distinction between UNEs and access services needs to be eliminated, with access charges, like UNEs, being set at Total Element Long Run Incremental Cost

(TELRIC) under a unified intercarrier compensation regime.[1] For the moment, however, the excessive access prices relative to *embedded cost* must certainly be eradicated before any further pricing flexibility or regulatory relief for the ILECs is allowed. In order to eliminate the excess earnings presently being generated by ILEC access services, all access rates should be reinitialized at their *current* embedded cost, based upon the last-authorized 11.25% rate of return.[2] With the *CALLS* plan expiring on July 1, 2005,[3] the ILECs that had previously been subject to price cap regulation should once again revert to that regulatory device, but with reinitialized going-forward rates and a productivity offset factor ("X factor") set to accurately capture the productivity growth experience specifically applicable to interstate access services.

- *Allow downward pricing flexibility to the ILECs.* ILECs assert a need for increased pricing flexibility – the ability to alter prices with short or no notice without first obtaining regulatory approval – in order to rapidly respond to the pressures of a competitive market. If the gas station across the street has just dropped its price for regular by five cents a gallon, you'd certainly want the ability to respond without first having to deal with a regulatory bureaucracy to gain approval. The problem is that, where pricing flexibility has been allowed, the ILECs have used – or more accurately, *abused* – their new freedoms to *keep prices high* and in some cases to *increase them*, not to lower them to the levels that have been required by price cap regulation in non-pricing flexibility areas. The ability of a firm to charge higher prices without losing so much business to competitors as to make those higher prices unprofitable – the classic evidence of market power[4] – should not be possible in a market in which actual and effective competition is present. ILECs should not *be able* to raise prices where competition is present, and thus have no legitimate need for pricing flexibility in the upward direction. On the other hand, ILECs should be allowed to reduce prices in response to competition. Downward pricing flexibility is a self-executing regulatory device that will automatically provide the appropriate regulatory treatment of ILEC rates without the need to assess the extent to which actual and effective competition is present with respect to any particular ILEC service.

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1. The FCC has indicated an interest in pursuing a unified intercarrier compensation scheme, but as of this writing no such rulemaking proceeding has been initiated. *See, Intercarrier Compensation Proposal Will Be Unveiled Soon, FCC Official Says*, TR Daily, May 19, 2004.

2. *Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers*, CC Docket No. 89-624, *Order*, FCC No. 90-315, 5 FCC Rcd 7507 (1990). As discussed more fully later in this paper, the 11.25% authorized rate of return was adopted in 1990. Interest rates are precipitously lower today, as such even a reinitialization of access rates at the 11.25% ROR level would be overly generous to the ILECs.

3. *Access Charge Reform*, CC Docket No. 96-262; *Price Cap Performance Review for Local Exchange Carriers*, CC Docket No. 94-1; *Low-Volume Long Distance Users*, CC Docket No. 99-249; *Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, *Sixth Report and Order in CC Docket Nos. 96-262 and 94-1; Report and Order in CC Docket No. 99-249; Eleventh Report and Order in CC Docket No. 96-45*, FCC No. 00-193, 15 FCC Rcd 12962 (2000) ("*CALLS Order*").

4. Karl E. Case & Ray C. Fair, *Principles of Economics: Annotated Instructor's Edition*, Prentice Hall, 1989, p. 308; William J. Baumol & Alan S. Blinder, *Economics: Principles and Policy*, Harcourt Brace Jovanovich, 1991, p. 689.

Re-targeting Switched and Special Access Prices and re-instituting annual price-cap X-Factor rate adjustments

For more than three decades, the FCC has sought to achieve cost-based rates for all telecommunications services. To this end, it has worked to reduce and ultimately eliminate subsidies – both explicit and implicit – that have historically been used to support a low priced entry platform, the (residential) dial tone exchange access line. The Commission's approach for achieving this outcome has had two principal components. First, it has encouraged the development of competition in those industry segments in which such competition would be feasible (initially customer premises equipment and long distance services) so as to drive prices down to cost. Second, for those industry segments in which competition was not present or could not be expected to develop to a point where it would be capable of driving prices to cost, the Commission has adopted a variety of pricing and other regulatory devices aimed at achieving that same overall "competitive outcome." By virtually any measure that effort has been largely successful. However, in recent years, the gap between access charges and costs has widened in large part because the competition in the interstate access market that had been originally anticipated has failed to materialize.

The "price cap" approach to regulating ILEC interstate services was put into effect in 1991[5] and has been revised several times.[6] These changes involved (a) increasing the X-factor from 3% in the original plan, ultimately to 6.5%; (b) eliminating the original requirement that "excess earnings" be shared with the ILECs' customers; and (c) excluding certain services from the scope of price cap regulation altogether.[7] Various parties, including Ad Hoc, have argued that the 6.5% X-factor was insufficient, and without further increase, excessive prices and returns would result. However, rather than implement additional increases in the X-factor, in 2000 the FCC adopted the so-called *CALLS* settlement under which further price cap rate adjustments for switched access services were suspended and replaced by a set of specific price reductions that would continue only until predetermined "target rates" had been achieved.

A central element of the Commission's rationale for eliminating the sharing requirement and for limiting the level of the X-factor was the expectation that competition for access service would develop and would act as a back-stop, constraining ILEC prices even if the specific price adjustments called for by the X-factor and by the *CALLS* settlement were by themselves insufficient to maintain the proper

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5. *Policy and Rules Concerning Rates for Dominant Carriers*, CC Docket No. 87-313, *Second Report and Order*, FCC No. 90-314, 5 FCC Rcd 6786 (1990) *("LEC Price Cap Order")*.

6. *See, e.g., Price Cap Performance Review for Local Exchange Carriers*, CC Docket No. 94-1, *First Report and Order*, FCC No. 95-132, 10 FCC Rcd 8961 (1995); *Price Cap Performance Review for Local Exchange Carriers*, CC Docket No. 94-1; Access Charge Reform, CC Docket No. 96-262, *Fourth Report and Order in CC Docket No. 94-1 and Second Report and Order in CC Docket No. 96-262*, FCC No. 97-159, 12 FCC Rcd 16642 (1997) (*"1997 Price Cap Review Order"*).

7. *1997 Price Cap Review Order*, 12 FCC Rcd 16645, para. 1.

alignment between prices and costs.[8] Indeed, the Commission expressed the specific expectation that by the termination date for the *CALLS* plan in 2004, such competition would have developed to the point where even continuing the *CALLS* plan would no longer be necessary, let alone reverting to price caps or to some other regulatory paradigm. Almost four years have now elapsed since *CALLS* was adopted, but the development of effective competition in the access market remains as elusive as ever.

The evidence presented in this paper (Chapter 3) clearly demonstrates that switched access prices are still recovering revenues substantially in excess of the embedded cost of providing those services. It also demonstrates that special access services – *that were themselves never specifically targeted to generate subsidies to any ILEC local services* – are being overpriced to an even greater degree. The idea of using interstate access as a source of subsidization for local service arose out of the break-up of the former Bell System *and at a time when Bell companies were expressly excluded from the interLATA long distance market*, and when most other ILECs did not themselves offer long distance services. Now that the BOCs and most other ILECs have entered the interLATA market, perpetuation of this access charge policy creates formidable market distortions and inappropriately benefits BOCs and other LECs – which do not pay the excessive access charges to themselves – while competitively disadvantaging interexchange carriers that remain subject to such excessive local access fees. Indeed, the use of access charges as a source of implicit subsidy to local service *is not allowable by law*.[9] More to the point, there is no indication that any of the excess profits *currently being generated by the overpriced access services* are actually even being used to support or subsidize basic local phone service.

The institution of subscriber line charges (SLCs) as a recovery mechanism for non-traffic-sensitive (NTS) RBOC costs, together with the FCC's substantial Universal Service Fund, have transformed the revenue recovery mechanism and in so doing obviated the need for any other subsidies to basic local service. Today, in 29 of the 50 states in which RBOCs provide service, the residential SLCs are *below* the FCC's SLC cap of $6.50 per month, and in 45 states the RBOC business multiline SLC is below the $9.20 business cap, confirming that the interstate portion of subscriber line costs is being fully recovered through those rate elements. The Primary Interexchange Carrier Charge (PICC), an additional per-line assessment collected from IXCs on business exchange access lines to make up the shortfall in those few states in which the SLC revenues do not satisfy the entire NTS revenue requirement, has been all but eliminated in RBOC regions.[10] As of May 2004, Qwest was the only RBOC still collecting PICCs, and its current PICC charge is $0.04 per business multiline per month. Clearly, there no longer remains any requirement for excessively priced switched and special access prices to subsidize the interstate portion

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8. *Id.*. at 12 FCC Rcd 16700-16701, paras. 148-153.

9. The Telecommunications Act of 1996 specifically required the FCC to make all subsidies explicit. Ad Hoc submits that The Act's language applies to *"cross-subsidies"* going to the RBOCs competitive operations as well.

10. While Ad Hoc would certainly welcome a move to TELRIC-based pricing for switched and special access services that would lower the overall NTS revenue requirements, this is not the specific proposal at this time, therefore we are not taking issue with the level of that NTS requirement. Ad Hoc's proposal contemplates the use of cost-based rates, based upon the traditional access tariff basis of Part 32 regulated costs, including a reasonable level of return.

of local service. Table 3.1 in Chapter 3 summarizes the overall interstate earnings of each of the RBOCs for 2003, the last full reporting period, and reveals those earnings to range from a low of 12% to a high of 24%.

Competition is not regulating access service prices

The evidence in Chapters 2 and 3 demonstrates that the FCC cannot rely upon competition in the access service markets to push access services prices down to just and reasonable levels. As we discuss in Chapter 3, earlier expectations that competition would discipline the market have proven false. Almost four years after the implementation of the *CALLS* plan, competition in local service markets has not driven the average switched access charge down below the $0.0055 per minute target rate and closer to cost -- in fact without the application of annual price reductions driven by the "X factor," the "Average Traffic Sensitive" (ATS) charge per minute has actually moved in precisely the opposite direction.[11] The existence of "competitors" in some highly limited areas of the special access market has done nothing to force special access prices closer to costs. Monopoly-level profits continue to be generated on these services, and these are eventually extracted from end-user business customers that rely upon special access facilities, who are being forced to pay prices that grossly exceed anything that would be found in a competitive market.

To eliminate the excess revenues being generated by interstate access services, the prices for these services (including those special access services that have been removed from price caps under the Pricing Flexibility rules) need to be re-targeted to a level not to exceed the FCC's most recently authorized rate of return for the RBOCs, i.e., 11.25%. Considering that the most recently authorized rate of return was adopted in 1990 at a time when the prime rate was 10% and the 10-year US Treasury Bond rate was 8.89% (September 1990), allowing earnings of this level would be extremely generous. Today, those rates are 4.25% and 4.73% (July 2004) respectively[12] – such that if the Commission were to actually reset an authorized return level, it would most likely be in the 8% to 9% range – considerably less than that now-ancient 11.25%.

Nevertheless, the Ad Hoc plan contemplates continued use of the 11.25% authorized return level and prices based upon embedded rather than forward-looking costs. However, these concessions are offered only for purposes of expediency. In order to simulate a competitive market outcome, access prices should be set based upon forward-looking costs, and absent that, a new, lower authorized return level should be used for re-targeting. As demonstrated on Table 1.1 below, reduction of existing special access prices to a level that would generate even the11.25% rate of return would result in elimination of more than *$5-billion* in excessive special access charges per year, or put differently, $15-million

11. See discussion at p. 39, *infra.*

12. Federal Reserve Board, *Statistics: Releases and Historical Data,* available at http://www.federalreserve.gov/releases/h15/data.htm#fn3, (accessed July 28, 2004).

dollars per day. Reduction of the earnings in the interstate access category in total (as opposed to special access services in isolation) to the 11.25% level would require a reduction of $3-billion in annual billing ($8-million per day). Customer that are presently being overcharged in excess of $3-billion per year should not be held hostage to protracted proceedings addressing the costing standard itself (embedded vs. TELRIC) or the authorized rate of return. If forward-looking cost studies were to take two years to be developed, litigated, and approved, another $10-billion in excess special access payments would have been imposed on corporate, government and institutional telecommunications users. Every day that the Commission does not act to correct the current situation costs large business and government users some $15-million – and confers an unjustified windfall to the ILECs.

The extreme disparity between switched and special access with respect to earnings requires that separate, service-specific X-factors be established for each. Special access demand has experienced unprecedented growth, and as the volume of units in service increases, the effects of economies of scale and scope work in concert to enhance productivity overall. The X-factor can best be determined through a detailed analysis of productivity growth experience coupled with an examination of input price changes. Alternatively, the Commission can apply the implicit X-factor methodology proposed by then-Common Carrier Bureau staff members Chris Frentrup and Mark Uretsky,[13] under which the X-factor is determined by calculating the value of the offset factor that would have been required to maintain RBOC earnings at their authorized level, i.e., 11.25%. In principle, both approaches should produce roughly equivalent results, but the implicit X-factor method can be implemented far more directly and more simply than the data- and analysis-intensive Total Factor Productivity (TFP) approach.

Table 1.1

2003 Total RBOC Overcharges

		Calculation	Total Interstate	Special Access
1	Average Net Investment		$31,983,983	$10,208,233
2	Net Return		$5,438,687	$4,486,021
3	ROR	Line 2 / Line 1	17.00%	43.95%
4	Approved ROR	11.25%	11.25%	11.25%
5	Tax Rate	39.25%	39.25%	39.25%
6	Overearnings	(Line 3 - Line 4) * Line 1	$1,840,488.91	$3,337,594.79
7	Overcharging	Line 6 / (1-Line 5)	$3,029,611.38	$5,493,983.19
8	Daily Overcharges	Line 7 / 365	$8,300.31	$15,052.01

Sources: Federal Communications Commission, ARMIS Report 43-04, Access Report: Table I YE 2003. Available at http://www.fcc.gov/wcb/eafs/ (accessed April 7, 2003).
39.25% is the composite tax rate currently used in the FCC's HCPM/HAI Synthesis Cost Proxy Model. http://www.fcc.gov/wcb/tapd/hcpm/welcome.html

13. *Price Cap Performance Review for Local Exchange Carriers,* CC Docket No. 94-1, *Fourth Further Notice of Proposed Rulemaking,* FCC No. 95-406, 10 FCC Rcd 13659 (1995), 13672, at para. 85.

Finally, in view of the persistent excessive earnings that the RBOCs have enjoyed under price caps, it has become abundantly clear that the sharing requirement must be reinstated. The RBOCs had claimed that imposing a requirement that they share "excess earnings" with ratepayers would erode their incentives to operate efficiently and to invest in the network.[14] But in its original ILEC price cap decision, the Commission had expressly relied upon sharing as a back-stop to protect consumers from excessive ILEC earnings in the event that the X-factor had been mis-specified. 20/20 hindsight and more than a decade of actual experience under price caps confirms that the X-factor had been mis-specified. In fact, on multiple occasions the Commission had determined that the X-factor needed to be increased. Even with those increases, RBOC earnings have continued to escalate to dizzying heights. Whatever efficiency gains the RBOCs may have achieved were not passed on to consumers in the form of lower prices. A sharing requirement still affords the RBOCs sufficient incentive to invest and to improve their efficiency, while at the same time assuring that consumers of monopoly RBOC services obtain some benefit from those improvements.

The Commission should implement a Self-Executing form of Pricing Flexibility for Special Access that does not require a competitive showing and that allows downward pricing flexibility where and when the RBOCs deem it necessary

ILECs argue that when competition is present for a particular service, consumers no longer require regulatory protection with respect to that service's price, and that ILECs can no longer afford the often protracted regulatory delays involved in modifying their prices in response to competitive initiatives. While that may be true, ILECs also have a strong incentive to seek pricing flexibility whether or not actual competition is present. Where competition exists, pricing flexibility enables ILECs to rapidly respond to the pressures of a competitive market. However, if competition is only present at an extremely incidental level but the ILEC nevertheless succeeds in convincing the regulator that effective competition exists, the ILEC achieves an even better outcome: It gains the ability to increase its prices without fear of any consequential competitive retaliation.

In the past, the FCC and various state commissions have granted ILEC petitions for increased pricing flexibility after a detailed review of evidence of the actual extent of competition present in the market for the service(s) in question. Since the actual extent of competition can vary from a nominal presence of one small provider with extremely limited capacity to widescale entry by large, well-capitalized firms, a good deal of regulatory effort in such pricing flexibility proceedings is consumed in gathering data on the actual presence of competition, and on arguing as to whether that presence is sufficient to obviate the need for continued price regulation. All of this takes time, and leads to outcomes that are less than satisfactory to all concerned.

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14. *See, e.g., Price Cap Performance Review for Local Exchange Carriers,* CC Docket No. 94-1, *Reply Comments of Bell Atlantic*, filed March 1, 1996.

Whatever justification any type of pricing flexibility might have with respect to the need to rapidly respond to competitive market conditions, no valid basis for *upward pricing flexibility* has ever been satisfactorily demonstrated. Indeed, if actual and effective competition is present, the ILECs' ability to raise prices would be largely foreclosed by competitive marketplace forces. *The very fact that ILECs seek authority to increase prices without regulatory justification and review cannot be squared with their claimed need to be able to "rapidly respond" to competitive pressure.* If competition is present, then what the ILECs need is *downward pricing flexibility*. And if all that needs to be granted is downward pricing flexibility, there is no longer a need for the Commission to affirmatively find that competition is actually present.

Downward pricing flexibility provides a *self-executing regulatory device* that will automatically assure the appropriate regulatory treatment of ILEC rates without the need to assess the extent to which actual and effective competition is present with respect to any particular ILEC service. Indeed, given the extraordinarily high profit levels that the RBOCs currently realize from their special access services, the suggestion that any sort of upward price movement should be permitted seems absurd on its face. When costs are declining, as in telecommunications, it should not be possible, as an economic matter, for an ILEC to increase its prices in a market in which actual and effective competition is present – in other words, if actual and effective competition really exists, ILECs would have no economic ability to increase prices even if, as a legal matter, they are permitted to do so. *Since ILECs should not be able to raise prices where competition is present, they have no legitimate need for pricing flexibility in the upward direction. On the other hand, ILECs should be allowed to reduce prices in response to competition.*

Allowing pricing flexibility in the downward direction only eliminates the need to evaluate the presence of competition or to utilize arbitrary "triggers" as a short-cut in lieu of more detailed examinations. Downward pricing flexibility is, in essence, a self-executing regulatory device that can operate effectively whether or not actual competition exists. Ad Hoc's plan is self-executing in that, if competition is present and works to force prices lower, downward pricing flexibility will assure the ILEC the ability and opportunity to respond to those competitive pressures. On the other hand, if there is no actual and effective competition, the regulatory protection of a price cap mechanism should operate to limit excessive prices.

Once existing rate levels have been reinitialized to eliminate the excessive prices that presently apply to access services, the Commission can then grant downward pricing flexibility, including contract tariffing authority, across all access markets. There would be no reason for the Commission to require an affirmative showing as to the presence of competition, or to evaluate the extent to which specific "triggers" have been satisfied in any particular market. This "self-executing" form of deregulation takes the Commission out of the debate over the actual level of competition, and offers all stakeholders – ILECs, CLECs, IXCs *and customers* – a level of regulatory certainty that exceeds anything that presently exists. Price cap regulation would continue in effect, but only for purposes of establishing ceiling price levels.